CONSTRUCTION RISK MANAGEMENT

SPECIFIED PERIL DEDUCTIBLES AND SUBLIMITS—IMPLICATIONS

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SPECIFIED PERIL DEDUCTIBLES AND SUBLIMITS—IMPLICATIONS

When examining the limitations of coverage under a builders risk policy, one must look beyond the exclusions. Of equal importance to ascertaining the restrictions upon coverage are the specified peril deductibles and sublimits that apply to certain causes of loss. Disputes will arise when there are disagreements about the scope and application of these provisions. Such disagreements may be the result of the insurer's failure to draft these provisions using clear and definitive language, or the policyholder's failure to review the provisions carefully. The outcome of such disputes can be a vastly different payout than expected by the losing party.

Background

A deductible is commonly understood as a particular sum that the insured must pay when a loss occurs before the insurer is responsible for any payment. The insurer's responsibility for the loss is the amount that exceeds the deductible, up to the policy limit of insurance. Thus, if an insured sustains a loss in the amount of $100,000 and its policy contains a $10,000 deductible, the insurer would be responsible for payment of $90,000. If the amount of the loss does not exceed the amount of the deductible, the insured's claim is technically not covered.

Importantly, most builders risk policies not only contain a standard deductible that applies on a blanket basis, but also one or more specified peril deductibles that replace the standard deductible with respect to losses arising out of certain stipulated causes of loss. Specified peril deductibles are usually greater than the standard deductible, thereby reducing the amount of coverage.

Sublimits also reduce the amount of coverage, but in a different way. A sublimit reduces the insurer's liability for losses arising out of particular causes to an amount that is less than the policy's standard limit of insurance. Recovery for earthquake, flood, and hurricanes, for example, is often limited to a specified sublimit. For example, a builders risk policy may offer a standard limit of $1 million for most causes of loss, but a maximum payout (i.e., sublimit) of $100,000 for earthquake, flood or "named storms."

The combined impact of a specified peril deductible and a specified peril sublimit is a squeezing of the coverage layer via a higher floor (the deductible) and a lower ceiling (the sublimit). Consequently, the insured's exposure is increased at both ends of the loss. Failure to adequately examine sublimits and deductibles for specific perils can therefore result in an illusion of coverage that is greater than the reality.

Builders risk insurers commonly invoke specified perils deductibles and/or sublimits for a variety of causes of loss, the most common of which are listed in Exhibit 1. These provisions are designed to reduce the insurer's exposure to certain types of claims. Often, specific deductibles and sublimits are invoked to reduce the insurer's exposure to catastrophic losses. (Catastrophic losses are those that affect a potentially large area simultaneously, as opposed to a specific property or location.) Builders risk policies covering property in a catastrophe-prone area, therefore, are more likely to have special sublimits and deductibles with respect to that cause of loss.

For example, policies covering property in California are likely to include special earthquake sublimits and deductibles, and those covering property in Florida are likely to contain special hurricane deductibles and/or sublimits. (Many builders risk policies now use the term "named storm" which has a specific meaning in the policy.)

EXHIBIT 1

SPECIFIED DEDUCTIBLES AND SUBLIMITS—COMMON APPLICATIONS

Hurricane	Wind	Loss of Property in Transit
Earth Movement	Flood	
Collapse	Soft Costs*	

*Soft costs are those that are not physical in nature, including lost profits, interest on borrowed money; realty taxes; advertising and promotional expenses; architects, engineers, and consultant fees; administration expense, etc. See section VII.B of this reference for a discussion of soft costs, or see *Terra-ADI Int'l Dadeland, LLC v. Zurich Am. Ins. Co.,* No. 06–22380–CIV, 2007 U.S. Dist. LEXIS 14620 (S.D. Fla. Mar. 1, 2007).

Insurers also consider the magnitude of the potential loss. Perils that have a high probability of exacting great damage to covered property are more likely to be accompanied by a higher deductible or a sublimit. A collapse, for example, usually involves considerable damage, if not total devastation, and the builders risk policy may limit the amount of coverage provided for that risk. Likewise, soft costs (e.g., lost profits or delayed project completion penalties) can rival, or even exceed, the cost of physical damage to the covered property, and are therefore a customary target of sublimits and specified peril deductibles.

Common Issues in Coverage Disputes

The precise wording of policy sublimits and deductibles is not always clear or specific. As a result, the understanding of the application, amount, and purpose of these restrictions may differ between the insurer and policyholder. The nature of the resulting coverage disputes is examined below.

Application of the Deductible/Sublimit

Ambiguities in policy language can lead to disagreements over the question of whether a specified peril deductible or sublimit applies to a particular cause of loss. For example, a dispute might arise over the issue of whether a "flood" deductible or sublimit applies to other forms of water damage, such as damage caused by a burst pipe. In the absence of a specific definition, insurers and insureds may argue about what constitutes a "flood."

Take, for example, the recent case of *Six Flags Inc. v. Westchester Surplus Lines Ins. Co.,* 2009 U.S. App. LEXIS 82723 (5th Cir. 2009) (interpreting Louisiana law) which concerned the application of an excess commercial property policy's flood sublimit to damage caused by a "Named Storm," which in this case was the infamous Hurricane Katrina. For purposes of the sublimit the definition of "flood" was as follows:

> The term "flood" is defined as loss or damage caused by waves, tidal water or tidal wave, overflow of streams or other bodies of water, or spray from any of the foregoing, all whether driven by wind or not. *Loss resulting from, contributed to or aggravated by a "flood" caused by a peril not otherwise excluded under this policy shall not be considered in application of the policy "flood" limit or deductible provisions.* [Emphasis added.]

[*Id.* at 26–27.]

Six Flags argued that the flood sublimit did not apply because the flooding was part of a "Named Storm" which was a separate cause of loss not excluded by the policy. The excess insurer, Commonwealth Insurance Company, countered that the flood sublimit applied to the actual flood component of the damage in question, but not to damage caused by the other components of the "Named Storm" such as wind, lightning, flying debris, and other storm damages. The court concluded that, based upon the ambiguity of the flood definition, the deductible did not apply to any of the damage caused by Hurricane Katrina, including the flooding that was a part of the hurricane:

> The Excess Insurers do not dispute that Hurricane Katrina was a Named Storm and cannot (at least at this time) dispute that Hurricane Katrina caused the flooding at issue here. Thus, under this interpretation, the Flood sublimit would not apply to loss resulting from the flood at the Six Flags New Orleans theme park caused by Hurricane Katrina.

[*Id.* at 27–28][1]

Another source of dispute arises when damage from a cause of loss that is subject to a specified peril deductible or sublimit ensues from a cause of loss that is not (or vice versa). For example, if a negligently maintained dam results in flooding to the insured property, do the standard provisions applicable to losses caused by negligence apply, or does the flood deductible/sublimit apply?

The case of *Turner Constr. Co. v. ACE Prop. & Cas. Ins. Co.,* 429 F.3d 52 (2d Cir. 2005) provides a clear example of how disagreements can arise over the interpretation of specified peril deductibles contained within a builders risk policy. *Turner* addressed the application a "wind" deductible to a loss involving rain damage. Notably, rain was an excluded cause of loss under the subject insurance policy, except in cases where rain enters an enclosed structure through means

[1] *Six Flags* also addressed the application of a flood sublimit under other excess policies insuring Six Flags. With regard to those other policies, the court held that the sublimit applied because the definition of flood within such policies was clearer and broader. "We conclude that the non-Commonwealth Excess Policies unambiguously establish that the Flood sublimit applies to loss and damage as respects Flood caused by, associated with, or occurring in conjunction with Hurricane Katrina." *Id.* at 26.

created by a covered cause of loss. In this particular case, the rain gained access to the interior of the structure through openings caused by wind, which was a covered cause of loss under the policy. However, the policy contained a "wind" deductible equal to 1 percent of the project's total value. The insurer argued that the wind deductible applied to Turner's loss because the force of wind enabled the rain damage to occur. Turner conversely argued that the deductible did not apply because the damage itself was caused by rain, not wind. Whether or not the wind deductible applied to the loss was vital because 1 percent of the project's value exceeded the amount of the loss, which would preclude any recovery under the policy. (For a discussion of percentage deductibles and how they apply, see section VII.A of this reference.)

Ultimately, the Second Circuit concluded that the wind deductible was not clear as to whether the deductible pertained to any loss involving wind or, instead, if it only concerned losses for which wind was the direct cause. Applying the well-recognized rule of insurance law that requires policy ambiguities to be interpreted in favor of the insured, the wind deductible was deemed not to apply. The court stated:

> The term "wind deductible" is not defined by the policy. Doubtless it applies to damage directly caused by wind; if a tornado leveled Turner's project, the wind deductible would apply. The damage in this case, however, was directly caused by rain, and only indirectly caused by wind. In other words, although wind created the opening through which the rain entered, it was the rain alone that caused the damage at issue.
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> …
>
> Nothing in the policy suggests that the wind deductible applies to damages only indirectly caused by wind…. Because the policy's "wind deductible" provision is ambiguous, in that it does not unambiguously apply to damages caused only indirectly by wind, we construe it to reach only those damages caused directly by wind.

[*Id.* at 54.]

The *Turner* case, however, was not free from dissent. Notably, one judge (Straub, J.) considered it illogical to avoid the application of the wind deductible when rain would have been an excluded cause of loss, but for the fact that it gained access to the building because of wind. Thus, for the reason that coverage for rain was linked to wind, the judge believed that it also should be linked to the wind deductible: "In sum, my wholly logical reading is that rain is never a Covered Cause of Loss as defined under the policy, and even where rain in fact causes damage, that damage is attributed to the Covered Cause of Loss that cause the opening and allowed the rain." [*Id.* at 56.]

As demonstrated by *Turner,* diverging interpretations of awkwardly worded deductibles are not only met with disagreement between policyholder and insurer, but may also be disagreed upon by the judiciary, or the trier of fact.

Amount of the Deductible

Even when the parties do not dispute that a specified peril deductible applies, the amount of the insured's deductible obligation is a potential source of conflict; especially when a percentage deductible applies rather than a fixed dollar deductible. A percentage deductible can be based on either the value of the insured construction project or the amount of the loss in question. Except in a total loss situation, a percentage of loss deductible would produce a lower deductible than a percentage of value deductible.

If an insured has an expectation of a percentage of loss deductible and finds out after filing a claim that the insurer is calculating the deductible based on the insured value, a dispute is likely. This point is demonstrated in *Caliber One Indem. Co. v. Wade Cook Fin. Corp.,* 491 F.3d 1079 (9th Cir. 2007).[2] In this case, earthquake damage of $8 million was insured under a policy that expressed the earthquake deductible as "5% deductible Earthquake per occurrence, minimum of $50,000." The policyholder argued that the deductible was 5 percent of the cost of the loss sustained, which was roughly $400,000. Alternatively, the insurer argued that the deductible was a percentage of the "total insured value" of the damaged structure, worth $13,902,000, for an amount of $695,100. Finding both interpretations to be credible, the court deemed the deductible provision to be ambiguous and thus looked to evidence outside of the policy to determine the parties' intended meaning:

> The district court did not err in finding ambiguous the 2000–01 policy definition of deductible—"5.00% deductible Earthquake per occurrence, minimum $50,000"—because nothing within that definition or the contract considered as a whole explains what figure serves as the basis for the 5% calculation. Nor does the clause become unambiguous if given its "plain, ordinary, and popular meaning," because the text's plain, ordinary and popular meaning is not evident…. Here, the policy does not explain whether "deductible … per occurrence" refers to the loss claimed or the total insured value of the property suffering a covered loss.

[*Id.* at 1084 (9th Cir. Wash. 2007) (internal citation omitted).]

The parole evidence revealed an understanding that the deductible applied to the total insured value.[3]

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[2]The *Caliber One* case involved a comprehensive commercial property policy, as opposed to a builders risk policy. However, with regard to the particular issue of deductible interpretation, the analysis is the same under both forms of coverage.

[3]The *Caliber One* court applied Washington law, which requires an examination of "evidence of the parties' intent and objective, the circumstances of its making, the subsequent conduct of the parties and the reasonableness of their interpretations" when a contract is considered ambiguous. *See Id.* at 11. However, if extrinsic evidence did not provide insight as to the parties' intent the court would have likely construed the policy language in favor of the insured, as is the rule in most legal jurisdictions. *See McCoy v. Federal Ins. Co.,* 7 F. Supp. 2d 1134, 1142–1143 (E.D. Wash. 1998) ("Generally, if an ambiguity persists in a contract after reference to extrinsic evidence, the rule of *contra proferentem* is applied and the ambiguous terms are construed against the drafter. With respect to insurance contracts, the rule of *contra proferentem* is strictly applied.")

Similarly, the use of a percentage deductible can create disputes with regard to how the base value upon which the percentage is determined. If the deductible states that it applies to the "total insured value" or the "insured value at risk," does it apply to the policy limit (i.e., the completed value of the entire project), the amount of work in place at the time of the loss, or some other definition of insured value?

A percentage deductible based upon the insured value at risk is generally understood to mean the total value of work in place at the time of the loss. Because project values change during the various stages of construction, the insured value at risk—and therefore the deductible—also changes. This is seen by many as a way of keeping the insured's share of the loss proportionate over the life of the project. However, if the language is not clear or specific, an insured could reasonably argue that the base value for calculating the deductible is the cost of a particular part of the project that sustained damage, or some other measure of value that is less than the entire value of work in place.

The insured in *Terra-ADI Int'l Dadeland, LLC v. Zurich Am. Ins. Co.,* No. 06–22380–CIV, 2007 U.S. Dist. LEXIS 14620 (S.D. Fla. Mar. 1, 2007) made an argument that illustrates the lack of clarity involving percentage based deductibles. *Terra-ADI* involved a "windstorm deductible" in the amount of "5% of the total insured values at risk at the time and place of a loss subject to a minimum of $250,000." [*Id.* at 2.] The project in question sustained hurricane damage, and thus the applicability of the deductible was not in dispute. Rather, the argument between the parties focused upon the interpretation of the language "total insured values at risk." The plaintiff (the insured) argued that due to the corresponding "windstorm" sublimit of $10,000,000, the "insured value at risk" was limited to the amount of coverage for windstorm, which was capped by the sublimit. The defendant (insurer) alternatively contended that the total insured values at risk was the value of the entire construction project, and that the windstorm sublimit had no relevance. The disagreement accordingly focused upon the base from which the percentage was calculated. As with *Turner*, the *Terra-ADI* court concluded that the deductible was ambiguous and, therefore, had to be construed in favor of the insured:

> Plaintiffs argue that "insured values at risk" refers to the value of property insured against "the peril of WINDSTORM." Indeed, the part of section 7(D) which reads "as respects the peril of WINDSTORM" can reasonably be interpreted as modifying that portion of the provision which reads "the total insured values at risk." Since there is a $10 million dollar sublimit on coverage against windstorm damage, Plaintiffs argue that $10 million dollars is the maximum "total insured values at risk …, as respects the peril of WINDSTORM." Accordingly, under Plaintiff's interpretation, the maximum deductible applicable to claims for property damage caused by a windstorm is $500,000 (5% of $10 million)….
>
> Zurich takes the different, but also reasonable, position that the "total insured values at risk" is the aggregate value of physical property insured under the policies—not merely the value of property insured against the peril of windstorm. Indeed, the provision can be read to suggest that, "as respects the peril of WINDSTORM", the deductible is "5% of the total values at risk …" as represented by the then value of the project. Under this interpretation, the "total values at risk" are the total values of all property at risk in general and the term "as respects the peril of WINDSTORM" simply distinguishes the

> deductible applicable to windstorm damage from the deductibles applicable to losses caused by other perils. According to Zurich, the provision does not make "the total values at risk" or the deductible a function of the $10 million sublimit of windstorm coverage....[4]
>
> The term "total insured values", as used in this case, is modified by the term, "as respects the peril of WINDSTORM." Therein lies the ambiguity that compels this Court's holding that section 7(D) of the policies at issue here is reasonably susceptible to differing interpretations and must therefore be resolved in favor of Plaintiffs. Accordingly, Plaintiffs are entitled to summary judgment as to Count II insofar as it relates to the proper calculation of the deductible applicable to property damage resulting from windstorm.

[*Terra-ADI,* 2007 U.S. Dist. LEXIS 14620, at 8–14.]

Courts have also considered the "values at risk" deductible issue in situations involving flood and earthquake damage. In *Landscapes Unlimited, LLC v. Lexington Ins. Co.,* No. 8:05CV425, 2006 U.S. Dist. LEXIS 84465 (D. Neb. Nov. 20, 2006), the insured had a commercial property policy providing a "value at risk" percentage deductible of 5 percent on a golf course construction project. When flood damaged a portion of the project, the insurance company calculated the deductible as a percentage of the total project policy limits, while the insured argued that the deductible applied to the flood sublimit of $500,000. The difference between the deductible interpretations was not slight. The insurance company's interpretation produced a deductible of $161,263.30 on the $407,733.18 loss, while under the policyholder's interpretation, the deductible was calculated as $25,000. As in the *Terra-ADI* case discussed above, the insured ultimately prevailed on the basis that that language of the deductible was unclear.

Similarly, in *Encino Oaks Homeowners Ass'n v. Associated Int'l Ins. Co.,* 2002 Cal. App. Unpub. LEXIS 7372 (Cal. App. 2d Dist. 2002), the court addressed this issue in relation to an earthquake loss. The insured's policy's "Deductible Endorsement" provided:

> The sum(s) shown below shall be deducted from the amount which would otherwise be recoverable for each loss separately occurring to the property covered hereunder from all perils insured against by this policy. [P] ... Earthquake: 5% of insured values per unit subject to $25,000.00 minimum per occurrence.

[*Id.* at 2–3.]

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[4]The *Terra-ADI* case actually involved damage that occurred at two separate construction projects known as "Metropolis I" and "Metropolis II." The two projects were insured by separate Zurich policies that contained the same or similar provisions. Zurich argued that the 5 percent deductible applied to the total value of physical property insured, as to each project. The respective policy declarations identified the value of "Metropolis I" as $31,500,000 and "Metropolis II" as $47,899,756. Thus, depending upon the level of completion, Zurich believed that the deductible could be as high as $1,575,000 for "Metropolis I" and as high as $2,394,988 for "Metropolis II." [*See id* at 13.]

The *Encino Oaks* court affirmed a trial court's lower ruling that the language was unclear:

> [The trial court] issued a detailed minute order which we quote at length: "1. The Court finds that the words 'insured values,' 'insurable values,' 'values at risk,' are not used as synonymous terms of art throughout the industry to denote the full actual value of the insured buildings (values at risk to insured) rather than to denote the portion of such values covered by the policy (values at risk to insurer). Contrary to AIIC's contention, the evidence established that there was no universal standard in the industry establishing that 'insured value,' 'insurable value,' 'values at risk,' 'values per unit' were understood to mean the same thing and were interchangeable. The Court found the testimony of [the Association's] experts to be more credible and invested with the greater persuasive force. The Court finds that it was not reasonable to impute such an understanding to [the Association] or its brokers.

[*Id.* at 16–17.][5]

The Purpose of the Specific Clause

A third source of disputes arising out of specified peril sublimits involves the nature, or purpose, of certain insurance policy language. When addressing specified perils, policy language is sometimes unclear as to whether it is imposing a sublimit, or instead, providing an extension of coverage. In other words, if the policy language does not sufficiently indicate that coverage for the identified cause of loss is restricted to an amount *below* the standard limits, the insured may argue that it is instead affording coverage for that peril that is *in addition* to the standard limit.

To illustrate, if a builders risk policy with a standard limit of $1 million states that it provides $100,000 for "debris removal" costs, the parties may differ in their interpretations of that language. The insurer may conclude that the most it will pay for debris removal is $100,000—i.e., that the provision operates as a sublimit. The insured, on the other hand, may read this language to say that not only does the policy cover debris removal within the standard limit, but also provides up to $100,000 in additional coverage for debris removal. The amount of coverage available for a given loss can be dramatically different under the

[5]The summary of this case continues:

> Particularly noteworthy to the trial court was the fact that AIIC was unable to firmly establish that the term "insured values" had the same meaning as the term "insurable values" in the insurance field. The Association's expert witnesses testified that the two terms had different meanings. Although Urrutia and others testifying on behalf of AIIC expressed the belief that the term "insured values" had the same meaning as "insurable values" or "values at risk," there was nothing concrete to back up their opinion, such as use of the term "insured values" in a document, letter, or memorandum discussing the deductible or in a policy issued by a rival insurer. Nor was AIIC able to establish a clear meaning of the term "values at risk," a term occasionally used in communications between the parties in negotiating the insurance. The Association's expert witnesses testified that both terms were ambiguous. Although AIIC established that these witnesses were not experts in the underwriting of commercial earthquake policies, it presented no reason as to why only those with expertise in that narrow area would have knowledge of general terms used in policy deductible provisions. [*Id.* at 35–36.]

different interpretations, as demonstrated in *RLI Ins. Co. v. Highlands On Ponce, LLC,* 635 S.E.2d 168 (Ga. Ct. App. 2006).

In *Highlands,* a fire occurred at a construction project which resulted in significant loss, including damage attributable to "soft costs," including additional interest expense, property taxes, and advertising expense. The project was insured by a builders risk policy issued by RLI Insurance Company, which contained a provision entitled "additional limits of insurance" for "soft costs" in the amount of $100,000. The parties disagreed over the nature of the provision. The insurer believed that the $100,000 limit was the sole amount of coverage for soft costs. The policyholder countered that soft costs were covered under the general coverage limits of approximately $29 million, and that the $100,000 was an additional amount specifically earmarked for soft costs. The *Highlands* court acknowledged the quagmire created by the lack of clarity of the provision, and remanded the issue to the jury.

> [T]he provisions regarding blanket liability and additional limits of liability were ambiguous such that the language is subject to more than one reasonable construction. On the one hand, the contract could be interpreted to mean that soft costs and business costs are limited to $100,000 per occurrence, irrespective of the blanket limit of $29,507,000. On the other hand, however, given the clause that "additional limits" apply in addition to the blanket limit of liability, and soft costs and business costs were identified as having additional limits of $100,000, the contract could also be interpreted to mean that once the blanket limit has been exhausted, there remained $100,000 for use to pay for liabilities in soft costs and business income over and above the blanket limit.... [E]ven applying the rule that any ambiguity will be construed most strongly against the drafter, the agreement between the parties remains ambiguous as to whether the coverage for soft costs and business income exceeded $100,000. Thus, it is for a jury to consider the circumstances surrounding the transaction to determine the scope and effect of the policy between RLI and Highlands.

[*Id.* at 172.]

While perhaps not common, the failure to label a provision as a sublimit or extension, or otherwise indicate that the clause is intended to limit or expand coverage, can nevertheless result in coverage disputes.

Conclusion

A prudent contractor should understand the full implications of the limitations imposed upon its insurance coverage for any given project, including the less obvious restrictions created by sublimits and specified peril deductibles. Similarly, a prudent insurer should choose language that clearly describes the application, nature, and scope of these limitations in order to avoid disputes over vaguely worded deductible and sublimit provisions. Because a significant amount of coverage is often at stake, nonspecific or clumsily worded provisions can lead parties down the road to unwanted litigation, and leave at least one party with an outcome that does not match its expectations with regard to the coverage provided under the policy. Insurers should be particularly careful in the drafting of clear policy language given the fact that, in most cases, ambiguities are construed in favor of the policyholder.